Transfer Pricing. Switzerland: Trends Developments

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Trends and Developments

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Introduction

One of the central motivations behind the OECD's work on the base erosion and profit shifting (BEPS) project is the desire to align a multinational company's (MNC's) profit with value-creating activities. The project brought about significant changes to the OECD Transfer Pricing Guidelines (OECD TPG). Its transfer pricing analysis framework explicitly recognises that the role of the significant people functions, the critical business decisions they are making and the operational risks they are controlling are leading when deciding how transactional results should be allocated over entities/jurisdictions.

Updates of the OECD TPG have been ongoing since 2017, covering, amongst others, specific guidance on transactions involving intangibles (introducing the concept of DEMPE, or development, enhancement, maintenance, protection and exploitation), business restructurings and financial transactions. Most recently, guidance on the impact of COVID-19 was issued.

In addition, there is significantly expanded cooperation in the field of tax law. The exchange of information has been considerably expanded with the BEPS project. Not only country-by-country reporting, but also the spontaneous exchange of information, EU Council Directive 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (also known under the acronym DAC 6) and, last but not least, the exchange of information upon request need to be mentioned in this regard. Together with simultaneous, bilateral and multilateral joint audits, the states have new information channels in their hands, which have not only led to increased audit activity in the area of transfer pricing, but also to the definition of transfer pricing audit priorities.

All these developments have a substantial impact on how intercompany transactions are analysed by MNCs as well as tax authorities. MNCs based in Switzerland are affected differently by these developments.

The liberal economic system, in particular the liberal labour law, good infrastructure, the first-class education system as well as the comparatively moderate corporate tax burden are reasons why Switzerland is a popular location for group headquarters and entrepreneurial activities that yield high residual profits, despite internationally rather high labour costs. Given this situation, it is not surprising that foreign tax authorities are particularly interested in intra-group transactions with Swiss companies. But the Swiss tax authorities are also increasingly auditing transfer prices. The experience of recent years and case law show that the Swiss tax authorities make increasing use of the OECD TPG as updated in 2017 to review intra-group transactions. Intra-group transactions with companies that are domiciled in tax havens or in countries with attractive tax regimes are particularly scrutinised.

Current transfer pricing issues also arise in connection with financial transactions and transfer pricing adjustments that were made due to the COVID-19 pandemic.

The increased relevance of transfer pricing issues in Switzerland has finally led to new legislative developments in the field of dispute resolution.

Impact of the 2017 Update of the OECD TPG on Swiss Practice

The allocation of returns between related parties was previously often based on the premise that risks and, hence, high-return rewards could be contractually allocated to a party in a (low-tax) jurisdiction even though that party had no significant people functions located in that jurisdiction. The 2017 update of the OECD TPG, following Actions 8–10 of the BEPS project, now stipulates that MNCs will have to identify all economically significant risks per transaction and to determine which party of each transaction controls the risks (ie, which party makes the decisions to take on, lay off and mitigate such risks) when defining the transfer pricing methodology. The contractual arrangement is still the starting point of a transfer pricing analysis, but when not aligned with actual allocation of the functional control of risks, the latter will lead in deciding on the transfer pricing outcome.

The 2017 update of the OECD TPG also introduced the DEMPE analysis as a new way of dealing with transactions involving intangibles. The DEMPE analysis, also stemming from the same effort of creating a clear link between economic substance and profit recognised in a jurisdiction, required responses to the questions regarding who within the MNC undertakes and, more importantly, who controls the DEMPE functions of the intangibles under review, and who bears the relative risks and owns the associated assets. The MNC should not only consider what meaning and relative importance can be attributed to the DEMPE functions in its particular industry and company structure but also needs to establish the location of the functions and their relative significance. After having delineated the intangible related transaction, the pricing of these transactions needs to be determined.

Additionally, the OECD TPG updated the sections on business restructurings. The actual transactions, including the accurate delineation of the transactions comprising the business restructuring and the functions, assets and risks before and after the restructuring will need to be determined. If something of value is transferred from one group entity to another in that business restructuring transaction, the pricing needs to be established in line with the arm's-length principle; more specifically, a transfer of something of value will require an assessment under transfer pricing business restructuring provisions and the "options realistically available" to the transferor will need to be considered.

The above-mentioned 2017 updates to the 2010 OECD TPG were generally considered a mere clarification of existing principles rather than a revision of the guidelines and therefore had immediate impact. The authors observed soon after that, in structures involving Swiss entities, the tax authorities started to require the taxpayers in tax audits, litigation, advance pricing agreements (APAs) and mutual agreement procedures (MAPs) to substantiate their position using analytical frameworks as they were explained above and laid down in the 2017 OECD TPG. One important consequence of the BEPS project in general and the 2017 update in particular was that over the past few years, taxpayers have, as part of their transfer pricing risk management and under pressure from the tax authorities, unwound structures lacking the necessary substance and/or adjusted the transfer pricing approaches.

Controlled Transactions with Low-Taxed Companies

The increased awareness of transfer pricing issues is also reflected in the way the Swiss

tax authorities deal with controlled transactions between Swiss companies and low-taxed foreign companies. Whereas in the past the tax authorities examined offshore companies primarily from the perspective of the place of effective management or general anti-avoidance rules, today the focus is more on transfer prices. This is evidenced by a look at recent Federal Supreme Court rulings in which transfer prices in the financial services industry were put to the test.

In its ruling of 27 September 2019 (2C_343/2019), the Supreme Court had to deal with a Geneva-based company, A SA, that belonged to an internationally active private bank and provided activities related to the management and administration of trusts and companies, as well as related advice and services. A SA held 99% of the shares in A Ltd, a company domiciled in the Seychelles. Under a service agreement with A SA, A Ltd was responsible for the registration and management of companies, the representation of companies before local authorities in the Seychelles and co-ordination services. A SA wanted to support the transfer prices it paid by the application of a comparable uncontrolled price (CUP) method. For this purpose, it submitted excerpts from websites showing the prices charged by competitors.

The tax administration of the Canton of Geneva considered the Seychelles company to be rendering routine functions. Applying the cost plus method, A Ltd was allowed a compensation of 5% of the expenses. A Ltd's profit, reduced by this compensation, was therefore allocated to A SA. In addition, a fine was imposed on A SA, which amounted to three quarters of the unlawfully avoided taxes. The Federal Supreme Court confirmed the decision of the tax administration. In its ruling, it highlighted several important points to be considered in the administrative and judicial review of transfer pricing.

According to the Federal Supreme Court, the OECD TPG are also applicable to transactions with offshore companies that are not resident in a double taxation agreement country. The version applicable should be the one that was current at the time of the taxation periods. Pursuant to the Federal Supreme Court, this was the version published in 2010, although the audit conducted by the administration also concerned the tax periods 2008 to 2009.

The Federal Supreme Court reiterated that the tax authority has to prove that the remuneration paid by A SA was not proportionate to the services provided by A Ltd. However, if the tax authority provides sufficient evidence that such a mismatch exists, it is then up to the taxpayer to prove the validity of its own standpoint.

The Federal Supreme Court concluded that – taking into account the functional and risk analysis, which showed that the subsidiary only provided services with little added value and that the risks in relation to the clients were borne by A SA, and the fact that A SA nevertheless repeatedly incurred losses – the lower court was entitled to reverse the burden of proof. The comparable prices presented by A SA were not sufficient to prove to the court their alignment with the CUP method. According to the Federal Supreme Court, A SA would have had to prove on the basis of a comparability analysis – in which, according to the OECD, five comparability factors have to be taken into account – that the transactions used were, in fact, uncontrolled transactions to which the intra-group transactions were comparable.

The case reveals two important findings that are also relevant for other transfer pricing audits in Switzerland: the functional analysis, together with the comparison of the profit margins achieved by the companies involved in the transaction can be used by the tax authorities as

an indication that the agreed transfer prices do not stand up to the arm's-length comparison. If the company examined by the transfer pricing audit now wants to prove that the transfer prices are nevertheless at arm's length, it must use a properly documented comparability analysis to show that the transactions used in the benchmark analysis are actually comparable, otherwise they will not be accepted as evidence by the tax authorities.

In another ruling, issued on 20 December 2019 (2C_1073/2018, 2C_1089/2018), the Federal Supreme Court had to decide on the arm's-length conformity of asset management services provided by the Geneva-based asset management company A SA to C Ltd, a Guernsey-based subsidiary. The latter acted as manager of various investment funds and was responsible, inter alia, for determining the investment strategies, distributing the fund interests or managing the fund assets on behalf of the investors. For its activities, C Ltd received a fixed fee based on the net asset value of the assets under management and a performance fee. The management activities, however, were partially delegated to third parties and to A SA itself.

In the course of a transfer pricing audit concerning A SA, the following issues arose. First, should A SA have received 70% of the performance fees received by A Ltd for its advisory activities, as was the case with certain third parties to which C Ltd delegated its services? Secondly, should A SA also have received an order placement fee for all funds for which it provided investment advice? Thirdly, should A SA have received remuneration for its sales and marketing activities over the entire period covered by the proceedings and how should this have been determined?

With regard to the issue of the performance fees paid to A SA, the Federal Supreme Court could refer to internal comparables. These transactions with unrelated parties to which C Ltd delegated investment advisory activities demonstrated that these parties received a performance fee of 40 to 70% of the performance fee C Ltd itself received from its clients. Thus, the tax administration was entitled to assume that a deemed dividend existed. The question was now whether the tax authority had the right to base the adjustment on the highest value; ie, 70%. The Federal Supreme Court supported the tax authority's view based on a comparability analysis. The court found that A SA's activities were more extensive than those of the third parties.

Concerning the compensation for the order placement activities, it was disputed whether a remuneration of 0.09% of the net assets under management was due for A SA's advisory activities, especially in connection with funds of funds. The contract between C Ltd and A SA only provided a fee for order placing regarding the management of simple funds. The lower courts disregarded this contractual provision without relying on a comparability analysis or at least providing a coherent explanation. The Federal Supreme Court, however, concluded that the lower courts had not established why A SA – contrary to the contractual agreement – should have received remuneration for order placement activities concerning funds of funds.

With respect to the sales and marketing activities of A SA, the tax audit revealed that A SA was heavily involved in the sales and marketing activities of C Ltd in various respects. In order to measure the compensation for the sales and marketing activities, the tax authority relied on a list of 40 external comparables from 2013 and 2014, although the tax periods examined were 2003 to 2010. Based on the figures in this table, compensation ranged from 26.9% (lower quartile) to 58.92% (upper quartile with a median of 54.96%) of the management fee. To be conserv-

ative and to account for market volatility, the tax authority set the transfer price for sales and marketing activities at 40% of the management fee.

It is now of importance for practice that the Federal Supreme Court did not conclude that the administration acted unlawfully solely due to the fact that the tax authority took comparative values from 2013 and 2014. A SA should have specifically explained why the figures from 2013 and 2014 led to a disproportionate compensation of A SA. However, it failed to do so.

Like in the first case, the Federal Supreme Court affirmed the presence of criminal tax evasion. The Federal Supreme Court confirmed that a tax evasion is generally to be assumed if the reported earnings are the result of a violation of the accounting regulations. Further, the Federal Supreme Court also held that the violation of the arm's-length principle may constitute a tax evasion even if no violation of the accounting regulations occurred. This was the case because A SA was not sufficiently remunerated, which, according to the court, had to be evident to the responsible managers.

The two Federal Court rulings presented are not isolated cases. The practice of recent years shows that the Swiss tax authorities have obviously targeted controlled transactions between Swiss companies and foreign low-taxed companies.

When analysing these cases, it becomes apparent that the Swiss tax authorities and courts are continuously expanding their know-how in the area of transfer pricing. The tax authorities are also not reluctant to conduct criminal tax investigations, especially in connection with offshore companies. In the case of transactions between Swiss companies and those domiciled in low-tax countries, it is therefore also important in Switzerland to clearly regulate transfer prices in contracts and to back them up with OECD-conforming transfer pricing analyses. Due to recent rulings by the Swiss Federal Supreme Court, the Swiss tax authorities are particularly careful to check whether the contractually agreed rights and obligations are actually exercised. If not, there is a risk that the tax authorities will ignore the contracts and challenge the applied transfer pricing approach.

Financial Transactions

Recognising that financial transactions are complex transactions, the OECD published its Transfer Pricing Guidance on Financial Transactions (TPG FT) on 11 February 2020, which is now part of the OECD TPG. The OECD report covered the transfer pricing aspects of various intercompany finance transactions, such as loans, financial guarantees, cash pooling, hedging and captive insurance companies. The OECD now provides detailed guidance supporting taxpayers as well as tax authorities in analysing shareholder loans and in determining arm's-length interest rates. The TPG FT confirms that in the process of determining an arm's-length interest rate, the characteristics of loan instruments – such as credit risks, the term of the loan or the level of seniority – are relevant factors to be considered and the TPG FT provides a detailed analytical framework to accurately delineate and price intercompany loan transactions.

In this context, it is interesting to review the status of the circular letters containing the Swiss inbound and outbound safe harbour interest rates (one for loans denominated in Swiss francs and one for loans denominated in foreign currencies), which the Swiss Federal Tax Administration publishes by circular every year.

These circular letters play an important role in determining interest rates on intra-group loans, reducing the administrative burden of taxpayers resulting from preparing and maintaining transfer

pricing documentation for their intra-group loans. However, the circular letters do not differentiate the interest rate applied based on the characteristics of loan instruments. Therefore, relying on the safe harbour interest rates in cross-border intra-group loan transactions will likely lead to challenges by the other country's tax authorities, claiming that the Swiss safe harbour rates do not correspond with the arm's-length standard. Furthermore, within the setting of the EU, relying on the Swiss safe harbour interest rates may lead to additional DAC 6 reporting requirements.

First Experiences with the COVID-19 Pandemic Guidance

On 18 December 2020, the OECD published the OECD's Guidance on the transfer pricing implications of the COVID-19 pandemic (the "Guidance"). The Guidance focuses on the following four priority issues:

- comparability analysis;
- allocation of losses;
- the allocation of COVID-19-specific costs and government assistance programmes; and
- APAs.

The Guidance was not intended to replace or amend what is already included in the OECD TPG, but rather to illustrate the application of the arm's-length principle in the context of the COVID-19 pandemic.

MNCs with centralised business models have used Switzerland historically as their home for an "entrepreneurial entity" or "risk-bearing entity" that has both the management and the financial capacity to bear risk and should receive the residual profit or bear the residual losses related to the relevant intra-group transactions. These entities conduct transactions with entities that are performing "routine" functions, they are characterised as "limited risk entities" (exposed to less risks) and therefore they earn a more stable return.

The MNCs would typically aim to set the intercompany pricing of the routine entity through the transactional net margin method (TNMM). In applying the TNMM, the net profit of the routine or limited risk entity is expressed as a reasonable profit margin over costs, sales or assets employed. Benchmarking studies are performed using public databases to identify the profit margins of independent companies with a comparable functionality of similar companies based on certain quantitative and qualitative search criteria. A statistical interquartile range (IQR) is applied to the financial results of comparable companies to obtain the arm's-length range of profit margins.

One of the most critical questions on the table of MNCs with Swiss entrepreneurial entities during the COVID-19 pandemic has been: "Can entities operating under limited risk arrangements incur losses?" The prompt input from the OECD on this issue has been highly appreciated from the business community.

At the heart of the OECD response, the concepts of "control over risks" (CoR) coupled with the concept of "options realistically available" (ORA) can be found. The Guidance has made clear that reacting correctly to this issue – ie, deciding whether or not to share losses with the limited risk entity – requires an analytical review following the CoR and ORA concepts, whereby consistency with long-term transfer pricing policies cannot be overlooked.

In the Swiss practice, the authors have experienced that cantonal tax authorities are willing to discuss specific cases; for example, where the Swiss entrepreneurial entity was incurring (substantial) losses as a result of COVID-19. They accepted that position, but required the taxpayer

to explain its business case and – in reference to the Guidance – provide the reasoning why it was in line with the arm's-length principle that the Swiss entrepreneurial entity had been allocated a substantial part of these losses.

Outlook

The trend is clear: transfer pricing issues will keep on gaining importance in Switzerland in the coming years. In order to counteract the threat of double taxation, it is important that dispute resolution mechanisms are strengthened. Switzerland has taken important steps in this regard. In its international tax policy, it advocates the inclusion of arbitration clauses.

After Switzerland had already concluded a consultation agreement with Germany on the implementation of arbitration proceedings in 2016, further agreements with Norway, the United States and Australia were added in 2019 and 2020. These agreements lay down the relevant procedural provisions for the conduct of arbitration proceedings. They are based on the so-called final arbitration method. Under this method, the competent authority of each contracting state must submit a proposal for a decision to the arbitration panel. In the course of its decision-making process, the arbitration panel has to decide in favour of one of the two submitted proposals.

The procedure is efficient in the sense that competent authorities will likely take reasonable positions when establishing their final offer, knowing that a less reasonable offer implies a higher risk of being denied during arbitration. This leads to a convergence of positions and provides an ideal incentive to the competent tax authorities to reach a mutual agreement, even before the arbitration procedure is initiated.

In addition to that, the Swiss legislator is committed to strengthen the rights and obligations of the taxpayer with respect to MAPs. Surprisingly, there is currently no legal basis in this respect. This is about to change: Parliament is discussing the Federal Law on the Implementation of International Agreements, which will regulate the application and the conduct of MAPs as well as the implementation of mutual agreement resolution into domestic law. The law is also to apply mutatis mutandis to APAs.

According to the current state of discussions, the right to be heard in the MAP is to be guaranteed as far as possible. Switzerland thus goes much further than other states: in particular, the persons requesting a MAP or an APA should also be able to comment on so-called position papers drafted by the "competent authorities".

Although Switzerland rejects joint audits, the draft provides that the State Secretariat for Financial Matters may, with the consent of the person making the request, conduct an inspection together with the competent authority if this serves to establish the facts of the case.

Finally, the proposal explicitly stipulates that compensation payments within the scope of "secondary adjustments", which Swiss companies have to pay to foreign group companies as a consequence of foreign profit adjustments, should not be subject to federal withholding tax, provided that such compensation payments are made as a consequence of a mutual agreement or a domestic resolution. Under current practice, the imposition of withholding tax was waived only if a mutual agreement was reached. If the bill becomes law in its current form – which is to be expected – Switzerland will have robust internal regulations for international dispute resolution and dispute prevention, which will further strengthen its position as a business location.

Tax Partner AG is focused on Swiss and international tax law and is recognised as a leading independent tax boutique. With currently 15 partners and counsels and a total of approximately 50 tax experts consisting of attorneys, legal experts and economists, the firm advises multinational and national corporate clients as well as individuals in all tax areas. A central focus lies on tax controversy and dispute resolution, including transfer pricing issues. Tax Partner AG also provides support regarding transfer pricing studies and the preparation of transfer pricing documentation. Other key areas include M&A, restructuring, real estate transactions, financial products, VAT and customs. Tax Partner AG is independent and collaborates with various leading tax law firms globally. In 2005 the firm was a co-founder of Taxand, the world's largest independent organisation of highly qualified tax experts.

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